Notes for Meeting of March 1, 2000
Market Mechanisms for Student Loans
(Student Loan Study Group 2--Section 801 Study)

Attendees

Maureen McLaughlin	Department of Education
Vic Rezendes	General Accounting Office
Barmak Nassirian	American Assoc. of Collegiate Registrars and Admissions Officers
Bob Scott	Ramapo College of New Jersey
Tony Dolanski	Sallie Mae, Inc.
Brad Svalberg	Student Loan Corporation (for Bill Beckmann)
Claire Mezzanotte	Fitch IBCA, Inc.
Jamie Pueschel	U.S. Students Association (for Kendra Fox-Davis)
Gail Norris	Utah Higher Education Assistance Authority
Pat Smith	American Association of State Colleges and Universities
Ivan Frishberg	U.S. Public Interest Research Group
Paul Wozniak	Paine Webber Incorporated
James Lintzenich	USA Group
Ed Martinez	UNIPAC (for Paul Tone)
Jacqueline Daughtry-Miller	Independence Federal Savings Bank
Scott Miller	Pennsylvania Higher Education Assistance Agency (for Michael Hershock)
Dick George	Great Lakes Higher Education Corporation
Mary Bushman	AFSA Data Corporation
Omer Waddles	ITT Educational Services, Inc. (for Rene Champagne)
Marilyn Quinn	Delaware Higher Education Commission
Harrison Wadsworth	(for Dick Pierce, Maine Education Services)
Robert Cumby	Department of the Treasury
Nabeel Alsalam	Congressional Budget Office
Wayne Upshaw	Office of Management and Budget

Other government staff:

Department of Education	David Bergeron, Daniel Pollard
General Accounting Office	Barbara Bovbjerg, Jay Eglin, Jim Spaulding, Mitch Rachlis, Kopp Michelotti, Gene Kuehneman, Rick Krashevski, Jon Barker
Department of the Treasury	Susan Lepper, Lucy Huffman
Office of Management and Budget	Lorenzo Rasetti
Congressional Research Service	Barbara Miles, Adam Stoll

Introductory remarks

Vic Rezendes welcomed participants and remarked that the world is very different from the world of 1965 when federal higher education loan programs started. He stated that this group would operate a little differently from the first study group. He sees this as a GAO and ED study that uses the study group as a sounding board. Maureen McLaughlin also welcomed the participants and stated that ED and GAO expect to be able to have a draft report by the statutorily specified date in November.

Jay Eglin discussed some operational issues including a schedule of meetings: GAO and ED anticipate about 4 meetings: this one, a second one in late March or early April, a third meeting in the summer, and a fourth meeting in September. He indicated that GAO and ED staff will assume responsibility for drafting a report and look to the study group for advice on the analysis. He anticipated that the report would not recommend a particular market mechanism but rather would provide information for the Congress to use in making decisions. He expects a first draft by November 15.

Jay also stated that GAO would host a web site for the study group. The site will include administrative info, such as agendas, member lists, and government contacts; market mechanism proposals and other papers; and a discussion forum, where study group members could post ideas and responses. GAO intends to control access to the web site through passwords. However, GAO recognizes (as should the members) that others may hear about the site and some members may share their passwords with others. Thus, nothing posted on the site should be considered confidential. He foresaw using the web site to disseminate information and ideas between meetings so that more time at meetings could be used for discussion and less for listening to presentations.

Study group members had comments and questions about the way GAO and Department of Education planned to proceed. Tony Dolanski asked why there would be no recommendations. Vic responded that the mandate does not require recommendations. Maureen agreed and also pointed out that the group is not designed to make decisions but rather to lay out options, to provide careful analysis while leaving program changes to policymakers. Tony noted that at the end, the draft would reflect its authors' biases; it would be difficult to produce a neutral and objective report. Maureen said that GAO and Department of Education will work together to make it unbiased. Vic noted how difficult it was to get agreement on the first study group.

Tony urged that the authors not exclude individuals' comments explaining different members' views. Maureen said they will not be excluded. Pat Smith noted that the mandate provides that "additional and dissenting views" be included.

Barmak Nassirian agreed that members' independent comments should be included. He asked about a timeline for the project and why GAO intended to password-protect the web site. Vic said that GAO and Department of Education hoped that a timeline would develop out of this meeting. Regarding the web site, he said that the study group is open to the public. However, we want members to be open and frank in expressing their views and expect that this will be more likely if we minimize publicity about the group's discussions. [Upon further discussion, the group agreed that the web site would generally be available to the public, but that access to the discussion forum would be restricted in some way.] Maureen noted that there will be a draft report for public comment. Omer Waddles said members should assume that anything discussed in the study group would be available to the public.

Barmak wondered what information study group members should share with their constituencies and asked if all information submitted for consideration would be made available to all members of the study group. Maureen said it would.

Bob Scott asked if the purpose of federal loan programs and the number of students served would be topics of discussion. He urged that the study group look at data about students. Vic thought that, when considering further research, the group should remember the very tight timeframe for the project. Barbara noted that effect on students was included in the 13 factors to be analyzed according to the mandate. Maureen said student data was available in the Department of Education and the study group will look at it.

Joe Flader, of Congressman Petri's staff, said that the study group deadlines could be extended. George Conant, of the House Education and the Workforce Committee staff, said a new deadline could be added to a technical amendments bill now being developed. To extend the public comment period to June or July of 2001 would be acceptable if the study group thought it needed more time. Joe said that the schedule in the mandate was designed so that the public comment period would occur during the post-election period in hopes that the report would get more attention at that time. The committee hopes that, with a new Congress and a new administration and extensive discussion of the issues, new policies will result. George noted that the change in rate determination due in 2003 is still on schedule.

Barmak said it was good that Congress was willing to wait for development of good information. Omer thought it was dangerous to delay, that changing the schedule would cause the project to lose momentum. Vic said adding new analysis tasks was not likely. Barbara said that the timeline for the project depends on the day's discussions. Harrison Wadsworth suggested returning to the schedule issue at the end of the day. Vic noted that we had about a month to decide if we want to propose that a schedule change be included in the technical amendments bill. Ivan Frishberg thought that if we want our reports taken seriously we should stick with the current schedule.

Pat asked why the first report was taking so long. Mitch Rachlis stated that it's because it is taking so long to get comments from members of the first study group, then to incorporate them and send them out for comment again. Vic stated that we would have firmer deadlines for the new project.

Department of Education presentation on student loans

David Bergeron gave a presentation about the two major student loan programs (see slideshow #1). Some highlights from his presentation: Total loan volume has increased by 58 percent from 1989 to 1999. About 1/3 of loans are direct loans and 2/3 are FFEL loans. About ¼ of loans are consolidation loans and ¾ are new loans; consolidation loans have increased as a share of all loans in recent years. Default rates have decreased dramatically: In 1990, the default rate for loans in their first 1 to 2 years of repayment was 22½ percent; in 1997, the rate was 8 percent. Students at public 2-year colleges borrow at very low rates and low volumes. Because they have low balances, we have to worry about them--they might be the most adversely affected by any decrease in loan availability. Gail Norris asked how much overlap there was between direct loans and consolidation loans. Claire Mezzanotte asked whether deferments masked the true default rates. Dick George noted that defaults over the life of the loan were more important than the measured default rate for the first 1 to 2 years of repayment.

David said that subsidy costs are lower for direct loans and even when administrative costs are included, direct loans save federal funds. Department of Education staff said their budget shop includes all administrative costs in their analyses and agreed everyone needs to think more about how to evaluate costs. There was some disagreement over the cost estimates, and Harrison Wadsworth asked whether other views about the analysis could be posted on the web site. Tony Dolanski asked that a slide be included in the presentation about the assumptions used. Maureen McLaughlin agreed that the presentation should show source of data. Nabeel Alsalam would like to see a breakdown of guarantee costs and subsidy costs for subsidized loans.

David said that loans are available to all students who need them. FFEL borrowers pay fees when they obtain loans—a 1 percent guarantee fee and a 3 percent origination fee. Nearly all FFEL guarantors currently waive the guarantee fee. A few lenders lower the origination fee. Overall, total FFEL fees average about 1.8 percent; for direct loans the total fees are 3 percent. The interest rate for students is T-bill plus 1.7 or 2.3 percent, but some FFEL lenders unconditionally discount the rate by .25, .50, or more. More typical is a discount conditioned on such factors as the borrower's use of electronic payment, or 48 consecutive months of on-time payments. Since 1992, students have been able to choose from a range of repayment plans (such as graduated or income-sensitive repayment).

Barmak asked if the discounts were guaranteed. If the loan were sold would the new holder have to honor the discount? Gail said that the discounts were generally in the lender's repayment procedures, not in the promissory note itself. Dick said that it depends on the program but the practice is widespread; sometimes it's contractual, and sometimes it's an additional offer that can be rescinded. Barmak noted that currently the economy is good; if things change, the discounts may not be permanent. He wondered if data were available on how many borrowers get discounts. Dick said ratings agencies could show aggregate amounts.

David continued that schools must meet eligibility requirements, including default rate thresholds, for their students to get loans. Schools become ineligible if their default rate is 25 percent or higher for three years. Schools may choose to offer FFEL, direct loans, or both. There are about 4,100 FFEL schools and 1,300 direct loan schools. Schools maintain lists of preferred lenders. Barmak said such lists may have a positive effect for the schools but there may be anti-competitive elements. This implies it's not a wide-open market. What mechanisms exist to get lenders added to a school's list? Scott Miller noted that this same point applies to the direct loan/FFEL choice as well. David added that there are 4,100 lenders in the FFEL program. Guaranty agencies pay off defaults and retain a share of their collections.

At the conclusion of the presentation, Tony objected to some of the content and expressed concern that if David's briefing document is posted to the web site it be labeled a Department of Education document, not a study group document. In particular, he felt that the slide on cost comparisons was an assertion, not a fact. Maureen said that the document would be labeled clearly as a Department of Education document. Mary Bushman pointed out that members may post dissenting opinions on the web site. Maureen said, as far as other viewpoints, Department of Education staff would not change their own documents but were happy to have documents arguing a different position also posted. Omer asked that the group keep in mind that the information provided was for the study group to use as they see fit in drawing their conclusions. Vic said we would post related studies and comments grouped together on the web site. Barmak felt that members can disagree but shouldn't object to having opposing views presented. Maureen said items on the web site would be labeled as the views of the submitter, not of the study group.

Bob wondered if, concerning means of delivery, the group should examine how other types of loans work, auto loans or mortgages, for instance. Omer mentioned farm loans as another kind of model but, he noted, the difference is that farm loans involve collateral. Marilyn Quinn mentioned examining the attributes of the credit/debit card system. Maureen asked about studying other countries' experiences. Vic thought these were issues for which the group could share any studies they were aware of that had already been done.

GAO presentation of issues specified in mandate

Barbara Bovbjerg briefly discussed the 14 criteria that the mandate states should be addressed for each model the study group analyzes (see slideshow #2). Members had comments on some of these issues.

Criterion #3—cost, effect, and distribution of federal subsidies—whether the group should discuss the general direction of subsidy changes—Barmak thought the statute required only a study of market mechanisms, not discussion of subsidy issues. Mary said the mandate stated that the study group should consider subsidy changes. Omer said that we had to define student loan participants and that students are participants. Gail recalled that the first study group had controversy over whether any savings should be shared with students. Joe Flader suggested the group not limit itself, that we consider the effects on students broadly. For instance, there is a question whether and how subsidies might be rearranged through more income contingent repayment (ICR). There was general consensus that the group must analyze how any change affects, even indirectly, borrowers' costs and savings (criterion 1) and subsidies for borrowers (criteria 3 and 4). There was not a consensus as to whether the group should rule out proposals that directly affect the borrower rate.

Criterion #4—ICR—Barmak wondered if the study group should look at whether ICR proposals include provisions to forgive unpaid balances after a certain repayment period and, if so, at whose expense.

Criterion #6—human capital, loan servicing capability, and quality of service to borrower—Barmak wondered if Department of Education would be included as a lender in discussions about upgrading systems. Jay Eglin thought Education would. Barmak felt that the student loan programs should not assume the cost of providers' infrastructure. Bob pointed out that the items in the slide are related to the actual wording of the study group mandate.

Criterion #10--Availability of loans to students by region, income level, and type of school—Bob thought that this factor should also take into consideration the level of accomplishment of students and their status within the academic system (e.g., remedial students vs. grad students vs. professional students), and that we should examine loan utilization by different kinds of students.

Criterion #13—transition procedures—Barbara pointed out that issues related to program transition and maintaining efficiency during transitions are near and dear to GAO.

General discussion of issues

Tony Dolanski specified several topics he thought should be addressed:

1. Risk sharing--even though there is 98percent reimbursement for defaults, there is still a certain amount of risk.
2. Role of the school—certifies eligibility and is a gatekeeper for access.
3. Disclosure--this is a bedrock principle of the marketplace. In any transaction, there should be disclosure about the borrower, the terms of the loan, and the pricing of loans.
4. Pricing of Direct Loans--how does the sale of Direct Loans fit into any market mechanism?
5. Consolidation loans—it's hard to analyze how they fit into the student loan picture.
6. Inducements—certain Department of Education regulations prohibit some kinds of arrangements; maybe this should be left to state laws.

Barmak asked to what extent the study group would consider non-auction models. Maureen said that the study group is not limited to auctions as a market mechanism.

Scott said that PHEAA uses loan proceeds to fund other programs, e.g., administrative costs for state grants; it does not use other state funds to pay these costs. Dick said the question of cross-subsidies would be too complicated and would bog down the study group. Barmak thought the study group should not be concerned about the use of loan proceeds.

Pat noted that it is appropriate for the study group to get into some issues that would involve the IRS. Therefore we should get Treasury officials involved in study group discussions, particularly concerning whether information could be provided in a timely manner. Lucy Huffman indicated that Treasury will participate in study group activities.

CBO presentation of a framework for considering options

Nabeel Alsalam presented potential considerations for our study (see slideshow #3). Some of the highlights of the discussion:

Nabeel said that one of the goals is to equalize returns over time and across students. There can be many strategies to accomplish this. The biggest problem with a single yield is that it applies across all students and all schools. Barmak said that Nabeel's analysis leads to more variability; there might be multiple add-ons for various kinds of loans. Nabeel said that multiple add-ons set by auctions would be an improvement. He noted that the Health Education Assistance Loan program currently just gathers information on rates lenders will accept for consolidation loans. We might distinguish between the ideas that "all students pay the same rate" and "all students are offered the same deal." Gail noted that this would allow rewarding borrowers with good payment records or rewarding student achievement. Nabeel noted that there are reasons of efficiency for lenders to do so. Omer noted that in the last Congress there was a proposal to reward student achievement. Nabeel indicated that would be a policy change.

Equalizing net lender returns over time assumes rational decisions on the part of lenders. Gail asked whether this meant equalizing returns for all lenders. Nabeel said it meant lender profits are stable over time.

One funding approach is for the government to provide funds to lenders at a certain rate (distinct from the borrower rate), which could be set by bidding. Lenders, including lenders who did not participate in the auction, could choose to participate at that level or raise funds on their own.

Pat asked about equalizing net lender returns--in a model with add-ons, would the add-on be bid or set in legislation? Nabeel said that it depends on the model--one could choose a reference rate, then determine various add-ons to that rate (by type of school, size of loan, level of student) through bidding. This would prevent creaming of the best loans. The best predictor of repayment is the previous payment record of students at that school. There is always some add-on that will make it attractive to lenders.

Program costs to the government related to loan guarantees are outside the scope of the yield question. In-school interest subsidies are purely an educational policy issue.

Ivan Frishberg thought that saying "there must be a better way to set lender yields" was too broad a statement. What is the problem we are trying to solve? Tony Dolanski said the reason the Congress set up the study group was to answer the question, "What should lenders be paid?" Nabeel said that the 1998 reauthorization was frustrating in that the almost total focus on lender interest rates distracted Congress from more important work. Tony asked whether a market model that would not require congressional involvement would be an improvement, and Nabeel said he thought so. Pat said freshmen were the riskiest borrowers. Nabeel thought more might be paid to lenders for freshmen loans and less for less risky loans.

Dick pointed out that lenders are different; they don't start from the same place when entering the bidding. Should they be paid differently? Nabeel recommended that the study group not deal with this. He thought that lenders should use their strengths and get help from others to offset their weaknesses. Barmak said that this could be problematic if the government prearranged who could participate. Dick said capital markets should also be considered. Barmak thought that government should not equalize the situation for all lenders. Dick noted that market mechanisms act differently for different kinds of lenders. Barmak thought it possible to separate financing from servicing, but should we settle on the cheapest funding mechanism? We don't want to end up with the cheapest financing if it means the lowest quality of loan servicing.

Omer said that having a critical mass of lenders in the program--through a subsidy structure sufficient to generate a choice of lender for all borrowers--may mean an advantage for the larger lenders and lead to further consolidation in the industry. But if there are fewer lenders, they may decide that some parts of the market are not worth pursuing. Having a variety of lenders and broad access to loans is important to the Congress.

Scott asked when the CBO study (per Senator Domenici's request) would be available. Nabeel said it was difficult to enforce deadlines for the information he needs so he could not be specific about timing. He hoped to get his study to the group for reaction soon.

General discussion of study group issues, approach

Barmak felt that the auction approach is too complex, and Nabeel's presentation only drove that point home. Within FFEL, securitization is something of a market mechanism approach. It allows one to sever the connection between financing and servicing. One could combine the two ideas of securitization and direct federal financing: Loans could be originated as Direct Loans are now, the government could immediately divest itself of the assets through securitization, and loans could be serviced privately as FFELP loans are now. Omer noted that this idea has been bouncing around since direct loans started. Barmak stated that the reauthorization allows Education to sell direct loans; this could be a starting point.

Robert Cumby asked why not consider public financing. Barmak thought there would be no cost advantage to his proposal but there could be a political advantage: some people object to government funding. There would probably be better servicing with securitization.

Dick George suggested testing the idea through auctions of different servicing arrangements: (1) loans and servicing; (2) loans only, with servicing arrangements at the buyer's option; and (3) servicing to specifications of direct loans.

Barmak also suggested considering other issues such as defaults. He stated there are three kinds of borrowers who default: (1) those who refuse to pay; (2) those who forget to pay; and (3) those who are unable to pay. For the first two, it should be a matter between the borrower and the note holder, perhaps with changes to the due diligence requirements. It's the third group we should be concerned about. Income contingent repayment could help this situation. Omer thought this was a good idea. Gail said costs would be higher if the servicer has to deal with ICR.

Pat asked about how loans would be originated in this model. Barmak thought that origination was different from the way it was 20 years ago, that it was largely mechanical; loan servicing is more important. Pat said it was important to avoid bundles of unattractive loans. We need to be concerned about how poor people are treated and how different institutions are treated when bundling loans. Marilyn Quinn pointed out that, for students, service quality is most important during repayment. On the other hand, schools are most concerned about loan origination issues and worry less about what goes on after the borrower leaves school. Tony Dolanski felt that schools are concerned about all aspects because they are affected by default rates.

Joe Flader noted the group had been discussing one proposal and suggested the group needed to get a number of proposals concretized for consideration. The study group could invite proposals from members or from outside the group.

Models/IDEAS proposed for study by Study Group

Proposed by Tony Dolanski:

1. "FHA" model: There would be a loan guarantee, similar to an FHA mortgage guarantee. Education would have loan servicing standards and anyone who wished to make loans would have to meet the standards. There would be limits on interest rates.

2. "Classic competition" model: Buyers and sellers of loans would meet with schools as gatekeepers to the marketplace. Thus the secondary market would determine the value of loans. Subsidies would be a separate issue. So the process would be similar to that for private alternative loans. Loan guarantees would still be necessary, as would some "lender of last resort" provision.

In response, Dick George brought up the idea of having Congress mandate securitization. This would get the market opinion of the proper rate. He added that the three servicing models he mentioned previously could supplement Tony's models.

Harrison Wadsworth wanted to assure that schools and students were kept whole; that is, they would continue to have the same access to loans and subsidies. (Even though subsidies are paid to the lenders, students get a better deal because of them.) Also, the lowest common denominator for loan servicing must be at a reasonable level of quality. Perhaps the delivery system for loans could be separate from the price of loans; that is, the origination of loans should be at the lowest cost to students and schools. The group should not do anything that might limit future improvements in either service or cost.

There was a question about the extent to which Education's Performance Based Organization (PBO--the Office of Student Financial Assistance) would be involved in the Study Group. Maureen replied that even though the Office of Postsecondary Education has the lead on policy issues for student loans, the department acts as a team. Therefore the PBO would be involved in Education's discussions of management and operational issues relating to student loans. Education's offices of General Counsel, Budget, and others would also be involved.

Proposed by Gail Norris:

1. "Blue Ribbon Commission" model: A politically neutral commission would determine the market rate to be charged for loans without actually conducting an auction.

2. "Incremental Adjustment" model: A rate would be set and then adjusted over time.

3. "Cost of Funds" model: Determine basic rate by cost of funds and add increments to the rate for various kinds of loans that require higher prices.

Next Meeting

Vic and Maureen proposed meeting again in late March or early April. After a comparison of calendars, and given several upcoming negotiated rulemaking sessions, it seemed that April 3 or 4 would be good for most members. GAO and Education staff will check into these dates and try to schedule the next meeting for one of them. [The second meeting was subsequently scheduled to take place on April 4 at the Department of Education offices at 1990 K St. NW, Washington, D.C.] Any members who had market mechanism proposals, or suggestions about the study group operations or work, were asked to send them to Jim Spaulding at GAO as soon as possible, not later than March 15.

GAO and Education staff agreed to put together a timeline for the study group and a statement of the scope of the work for distribution to the members. GAO will also let members know when the web site is available--anticipated to be at least a week before the second meeting.